March 2012/05

Issues paper

This report is for information

This report provides an overview on the financial health of the higher education sector in England. The analysis covers the 2010-11 financial results and 2011-12 forecasts, as submitted to HEFCE in early December 2011.

Financial health of the higher education sector

2010-11 financial results and 2011-12 forecasts

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND hefce

Financial health of the higher education sector

2010-11 financial results and 2011-12 forecasts

To	Heads of HEFCE-funded higher education institutions
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning
Reference	2012/**05**
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Enquiries to	HEFCE assurance consultants or assurance advisers
	There are searchable contact details for HEFCE staff at www.hefce.ac.uk/aboutus/cop/contact/

Executive summary

Purpose

1. This report provides an overview on the financial health of the higher education sector in England. The analysis covers the academic year 2010-11 financial results and 2011-12 forecasts, as submitted to HEFCE in early December 2011. The report is being published to provide universities and higher education colleges with feedback on their financial performance in 2010-11 and original estimates for 2011-12, before they submit their updated financial forecasts in June 2012 (as requested in HEFCE 2011/28). The analysis also provides other stakeholders with information about the current financial health of the sector.

Key points

2. Higher education institutions (HEIs) in England are required to send us their annual accountability returns in December each year. These returns form a significant part of the way in which HEIs can demonstrate accountability for the public funds distributed to them. The accountability returns enable HEFCE to reassess HEIs' overall risk assessments and to ensure that HEIs are meeting their accountability responsibilities.

3. For this year's process we deferred the submission of financial forecast data (relating to the academic years 2012-13 to 2014-15) and financial sustainability commentaries until 20 June 2012. The decision to defer submission was taken due to the degree of uncertainty in the sector about, among other things, student number limits, future HEFCE funding and student recruitment in the new fee regime. While it will not eliminate all of the uncertainty, deferral should enable institutions to produce more reliable forecast information in June 2012 for both HEFCE and internal use, because by then institutions will know the outcomes of the HEFCE grant letter from the Department for Business, Innovation and Skills (BIS) and will have a better indication of student demand in 2012-13. We will also have begun consulting on our future teaching methodology.

4. In June 2011 the Public Accounts Committee (PAC) published a report 'Regulating financial sustainability in higher education'[1] following a PAC hearing in March 2011. One of the recommendations in the PAC report was that BIS writes to the PAC by the end of March 2012 setting out how well institutions are coping with the transition to the new funding regime. The focus of this was on the risk to the financial health of institutions. The information in this report will support the response to be made by BIS.

5. Overall, the financial results for the sector in 2010-11 are stronger than those reported for 2009-10 (and much stronger than indicated in the sector's forecasts for 2010-11 submitted to us in April 2011). The majority of the key sector financial indicators are the best on record[2], with the sector reporting strong surpluses, large cash balances and healthy reserve levels. These will help the sector manage the financial challenges arising from the transition to the new funding arrangements.

6. The projected performance for the sector in 2011-12 is sound overall, and is expected to be better than the sector estimated in April 2011. This may be due to prudent forecasting earlier in the year, which is a pattern we have seen in previous years. Despite the overall soundness of the expected financial performance in 2011-12 there is clearly an implication of reductions in public funding which see projected surpluses reducing sharply.

7. Over the past decade the sector has seen its overall financial position strengthen, but this has been on the back of significant income growth rather than cost reductions. The future is likely to be less predictable for some institutions, and they will need to respond decisively to the new funding and policy priorities. The information to be submitted to HEFCE in June 2012 will give us a strong indication of how well the sector is responding to these challenges. In the meantime the financial results and forecasts already submitted to us suggest that many institutions are beginning to see the results of their strategies to restructure their cost bases in preparation for the transition to the new funding arrangements. In fact, in 2010-11, the sector recorded a real-terms reduction in its largest expenditure category – staff costs – for the first time since 1998. This is an important development, as income is projected to fall in 2011-12.

8. One of the key risks to future financial sustainability that was reported by institutions as part of our last annual accountability review was an unexpected fall in student recruitment and retention caused by the new fee proposals. The sector's latest financial forecasts for 2012-13 and beyond are not due to be submitted to us until June 2012. However, UCAS data[3] indicate that student demand for 2012-13, at sector level, appears to still exceed the supply of places available in 2012-13, certainly for home and EU full time undergraduates. Therefore at a sector level the immediate risk of an unexpected reduction in student numbers in 2012-13 appears to be low. However due to changes in government policy on student number controls for 2012-13, some HEIs may have fewer full-time undergraduate students starting studies in 2012-13 and future years. In such cases it is worth bearing in mind that financially the impact of such reductions will be mitigated by increases in student fees. There may also be some subject effects which are not yet apparent.

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[1] Public Account Committee reports can be found at: www.parliament.uk/pac

[2] Financial information has been collected by HESA since 1994-95.

[3] UCAS data can be found at: www.ucas.com/about_us/media_enquiries/media_releases/

9. There continues to be a large degree of uncertainty about how the new system will operate in the medium term (i.e. 2013-14 and 2014-15) in particular with regards to the policy of controlling student numbers. There is a risk of increased volatility in the future, and we will assess the potential impact of this once we receive HEIs financial forecasts in June 2012.

10. Based on the annual accountability returns submitted to us in December 2011 there are no institutions that are presently close to risk of insolvency. This is supported by independent going-concern opinions of institutions' external auditors, which were received as part of this review process.

11. We will publish an update on the financial health of the sector when we have received and analysed all HEIs' financial forecasts for the period 2012-13 to 2014-15. This will incorporate feedback to the sector on all of the annual accountability returns submitted in December 2011 and June 2012, including feedback on Transparent Approach to Costing (TRAC) returns and the quality of reporting for charity regulation purposes.

Action required

12. No action is required: this report is for information.

Overview

13. Higher education institutions (HEIs) in England are required to send us their annual accountability returns. These returns form a significant part of the way in which HEIs can demonstrate accountability for the public funds distributed to them.

14. We primarily use the information collected to:

- monitor the use of HEFCE funds for the purposes intended, including compliance with the Financial Memorandum[4]
- form a basis for discussion with institutions about their progress in key areas, their priorities for strategic development, and their current and future performance (including financial sustainability)
- largely determine our risk assessments for each institution
- identify trends across the sector and advise the Secretary of State for Business, Innovation and Skills on the needs and development of the higher education sector
- to monitor HEIs' reporting of information relating to their charitable status in accordance with our role as a principal regulator under the terms of the Charities Act 2006.

15. The annual accountability returns are also a key element of HEFCE's institutional assurance and risk framework. They complement our cycle of assurance reviews and data audits to provide a coherent regulatory approach to HEIs. The various accountability returns that HEIs submit to HEFCE provide assurance to all investors and to the community that each institution serves.

16. As last year, the accountability review process is being undertaken in two stages to coincide with the submission of annual accountability information. This is primarily due to our decision to defer the submission of financial forecast data (relating to the academic years 2012-13 to 2014-15) until 20 June 2012. The decision to defer submission was taken due to the degree of uncertainty in the sector about, among other things, student number limits, future HEFCE funding and student recruitment in the new fee regime. While it will not eliminate all of the uncertainty, deferral should enable institutions to produce more reliable forecast information in June 2012 for both HEFCE and internal use as institutions will know the outcomes of the HEFCE grant letter from the Department for Business, Innovation and Skills and will have a better indication of student demand in 2012-13. We will have also begun consulting on our future teaching methodology.

17. This report provides an overview on the financial health of the sector as assessed in the first stage of our annual accountability review process, and will provide universities and higher education colleges with feedback on their financial performance in the academic year 2010-11 and original estimates for 2011-12, before they submit their updated financial forecasts in June 2012. The analysis also provides stakeholders with information about the current financial health of the sector.

[4] For further information see 'Model Financial Memorandum between HEFCE and institutions: Terms and conditions for payment of HEFCE grants to higher education institutions' (HEFCE 2010/19). All HEFCE publications are available at www.hefce.ac.uk

18. The data used in this report come from two main sources. All data up to and including 2009-10 are from the Higher Education Statistics Agency's Finance Statistics Record, which is completed by all institutions each year. Information covering the period 2010-11 to 2011-12 is from HEIs' financial returns submitted to us[5]. Some comparisons are made to the financial results and forecast data submitted in April 2011. All financial information is presented in academic years (i.e. years ending 31 July). References to real terms changes in financial information take into account the latest available data on inflation produced by Government[6].

Headline information

19. Table 1 provides a summary of the key financial results for 2010-11 and shows the forecast performance in 2011-12.

Table 1 Summary of key financial indicators

	Actual		Forecast
	2009-10	**2010-11**	**2011-12**
Total income	£22,221M	£22,923M	£22,749M
Operating surplus	£708M	£1,062M	£270M
as % of total income	3.2%	4.6%	1.2%
Historical cost surplus	£805M	£1,314M	£458M
as % of total income	3.6%	5.7%	2.0%
Staff costs as % of total income	54.3%	53.0%	55.0%
Cash flow from operating activities as % of total income	8.3%	9.2%	4.5%
Net liquidity as no. days' expenditure	98	109	88
External borrowings as % of total income	21.1%	22.0%	23.9%
Discretionary reserves exc. FRS 17, as % of total income	46.0%	51.1%	54.1%

Financial performance

20. The overall financial results for the sector in 2010-11 show a healthy position. However, as in previous years, the sector-wide picture encompasses a wide range of results between institutions. The key messages from the analysis into the 2010-11 annual accounts are included in the following section.

Income and expenditure

21. Total income increased by £702 million (3.2 per cent) to £22,923 million during 2010-11, with the majority of this (£605 million) being due to a rise in income from tuition fees, which rose 8.5 per cent over the year. Table 2 provides a breakdown of tuition fee income.

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[5] The financial results and forecasts data used in this report exclude Leeds College of Music, which transferred to the further education sector on 1 August 2011. References to previous years (pre 2010-11) include the financial data for this institution.

[6] We have used the latest Gross Domestic Product deflators published by HM Treasury. The figures used were released on 22 December 2011 and can be found at: www.hm-treasury.gov.uk/data_gdp_index.htm

Table 2 Breakdown of tuition fee income

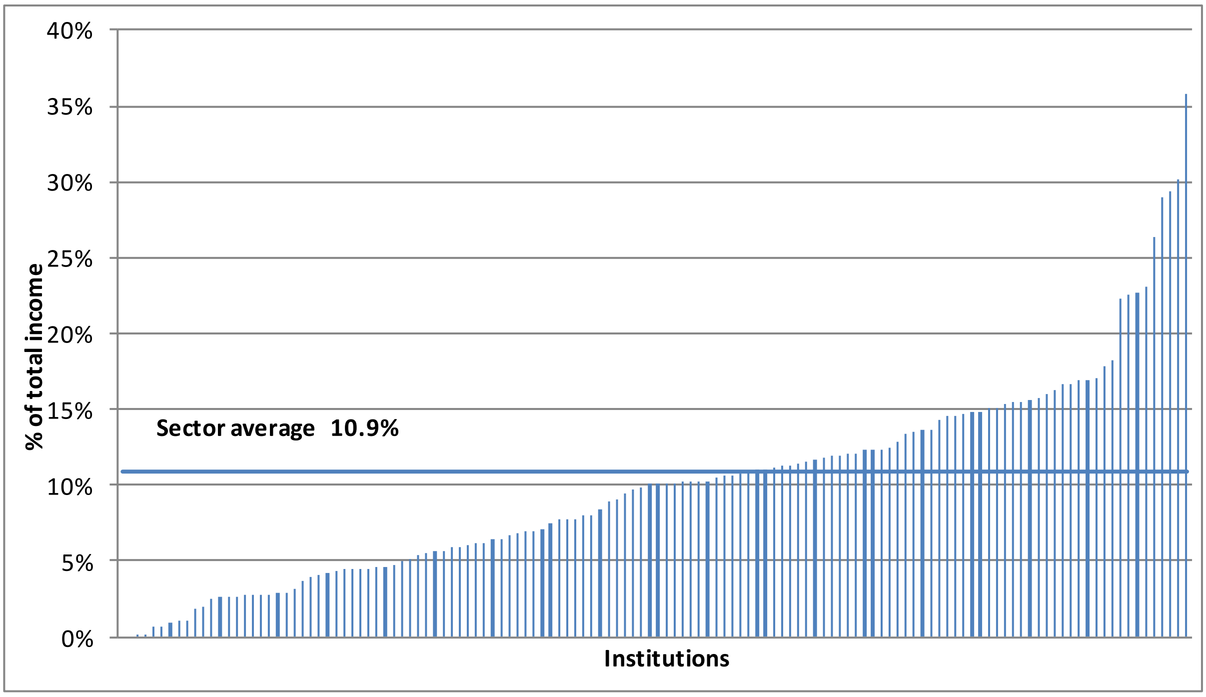
	2009-10	2010-11	% increase
FT UG (home & EU)	£2,693M	£2,877M	6.8%
FT PG (home & EU)	£510M	£536M	5.0%
PT (home & EU)	£524M	£540M	3.0%
Health (home & EU)	£725M	£744M	2.6%
Overseas	£2,154M	£2,498M	16.0%
Other	£544M	£561M	3.1%
Total fee income	**£7,150M**	**£7,755M**	**8.5%**

Note: FT – full-time; PT – part-time; UG – undergraduate; PG – postgraduate.

22. Table 2 shows that there has continued to be considerable growth in fee income from overseas students. Since 2000-01 this income stream has more than doubled in real terms and at the end of 2010-11 this income accounted for 10.9 per cent of the sector's total income, the highest on record.

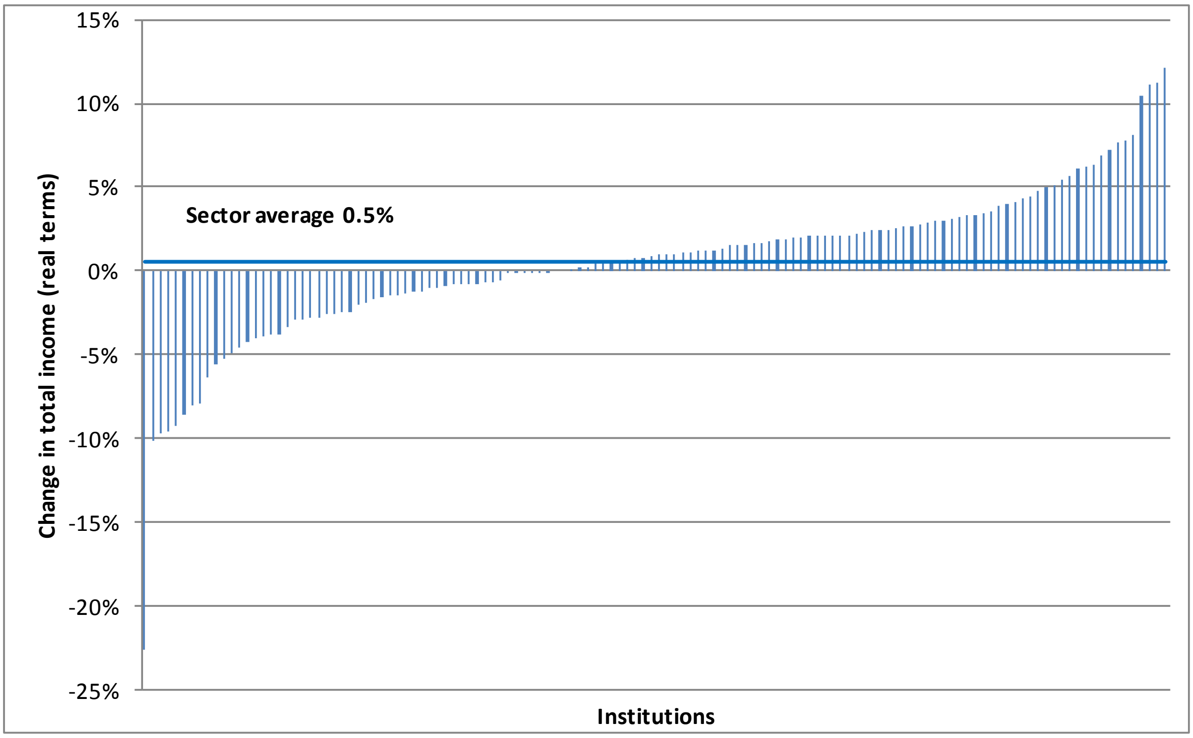
23. However, the dependence on this income source still varies between institutions, ranging from 0 per cent to 35.8 per cent of total income. As in previous years, the 20 institutions recording the most income from overseas fees account for nearly 50 per cent of the sector's total. This indicates that although almost all institutions receive income, the majority goes to a small group of institutions. Figure 1 shows the distribution last year.

Figure 1 Overseas fee income as percentage of total income (2010-11)



24. Despite the overall increase in total income during 2010-11, across the sector 52 HEIs recorded real-terms reductions in income over the year, compared with 20 HEIs in 2009-10. Twenty-three HEIs recorded actual cash reductions in income compared with 11 in 2009-10. HEIs recording cash reductions in the previous year tended to be small and specialist institutions; however in 2010-11, cash reductions in income were being reported more widely across the sector. The reductions were primarily due to lower HEFCE funding but also, in some cases, a fall in income from research grants and contracts. At the same time though, another eight HEIs recorded cash increases in total income of over 10 per cent. Figure 2 shows the wide variation in performance across the sector (in real terms).

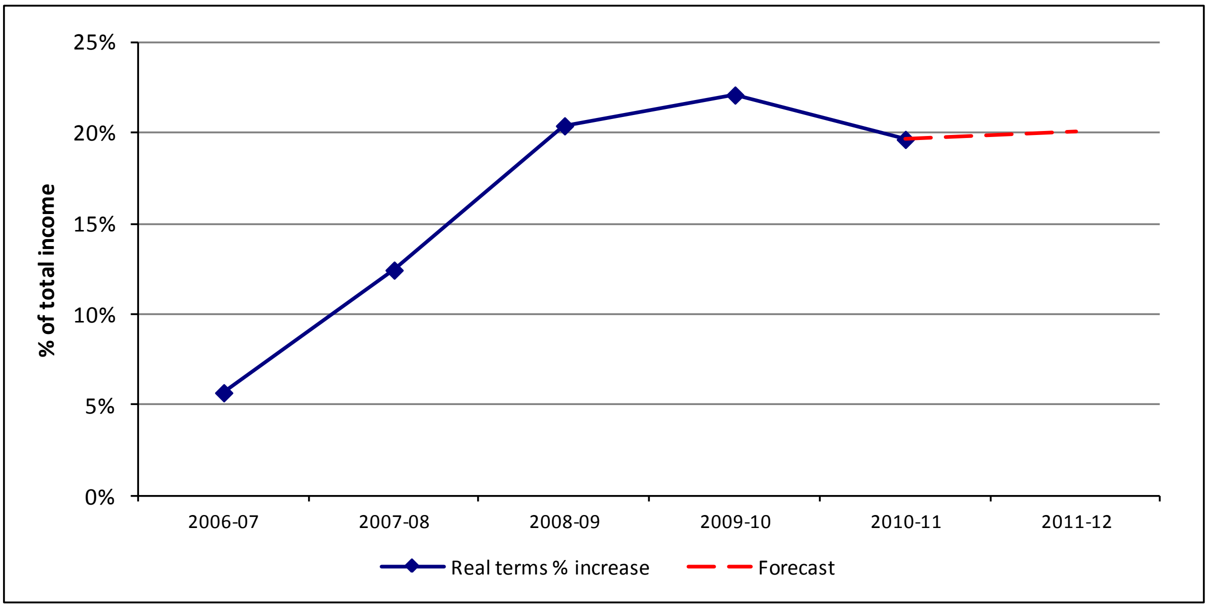
Figure 2 Real-terms percentage changes in total income (2009-10 to 2010-11)



25. In 2010-11 total expenditure rose marginally by 1.6 per cent in cash terms, compared to the increase of 2.9 per cent which was forecast in April 2011. The sector's biggest expenditure continues to be staff costs, which totalled £12,139 million in 2010-11 (53.0 per cent of total income). There has been a trend of seeing staff costs, expressed as a percentage of total income, reducing since a high of 58.1 per cent in 2000-01.

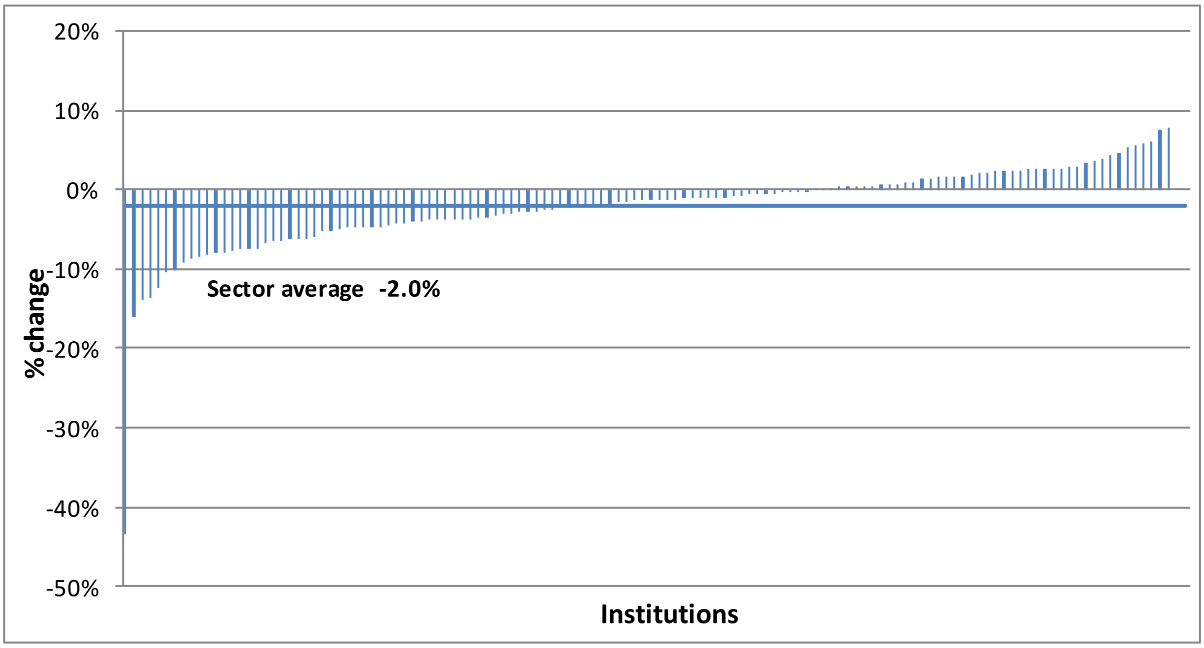
26. For the first time since 1997-98 staff costs fell in real terms (by 2 per cent). This follows a period of significant growth in staff costs; Figure 3 shows the cumulative change in staff costs (real terms) since 2005-06. The 2 per cent real terms reduction in 2010-11 was only the second time staff costs have reduced, in real terms, since financial information was collected across the whole sector (1994-95). The previous reduction was in 1997-98 in which staff costs reduced by 0.7 per cent. The reductions in 2010-11 and 1997-98 are certainly anomalies as since 1994-95 staff costs have cumulatively increased by 88.5 per cent in real terms.

Figure 3 Cumulative real-terms change in staff costs since 2005-06



27. The overall real-terms reduction in staff costs in 2010-11 was caused by a decrease in the total number of employees and a real-terms reduction in the average pay costs of employees. The overall reduction in staff costs across the sector masks considerable variation between institutions. Figure 4 shows the distribution of changes in staff costs across the sector from 2009-10 to 2010-11.

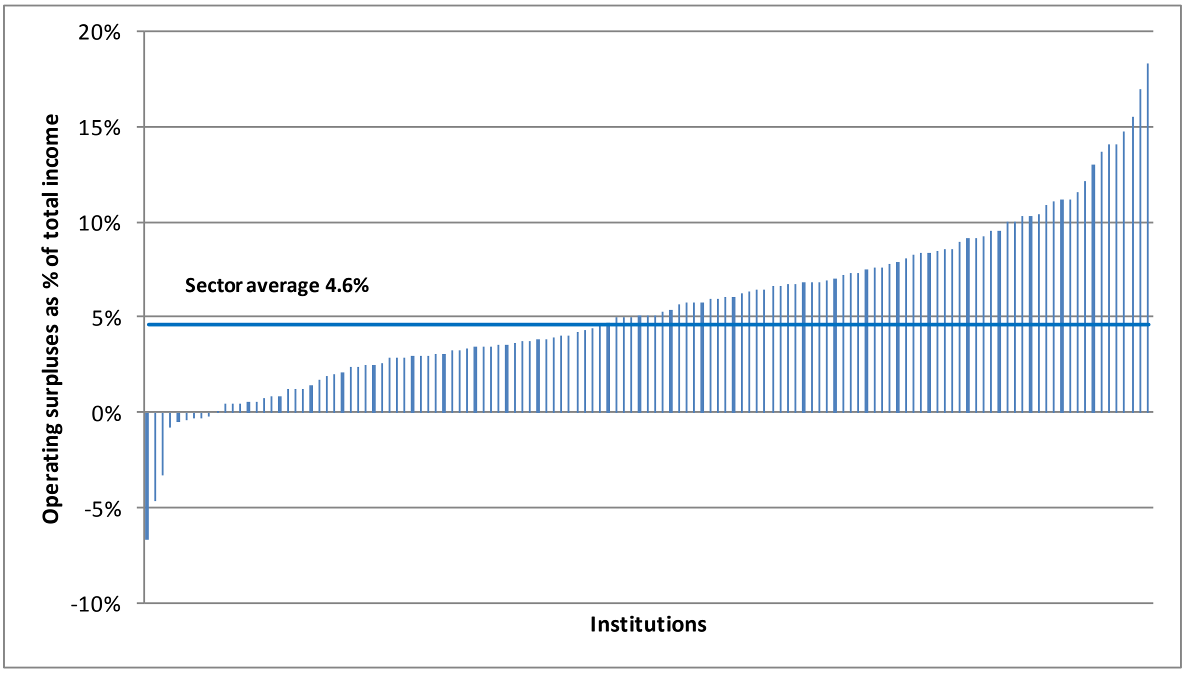
Figure 4 Real-terms percentage changes in staff costs from (2009-10 to 2010-11)



Surpluses

28. The sector's operating surplus (that is, total income less total expenditure before any exceptional items) rose significantly over the year from £708 million to £1,062 million (4.6 per cent of total income). This is significantly better than any previous year on record, and indicates that the sector is preparing for the transition to the new funding arrangements. Only nine institutions reported operating deficits in 2010-11, of which six recorded deficits of less than 1 per cent of total income. Figure 5 shows the level of operating surpluses as a percentage of total income reported by institutions in 2010-11.

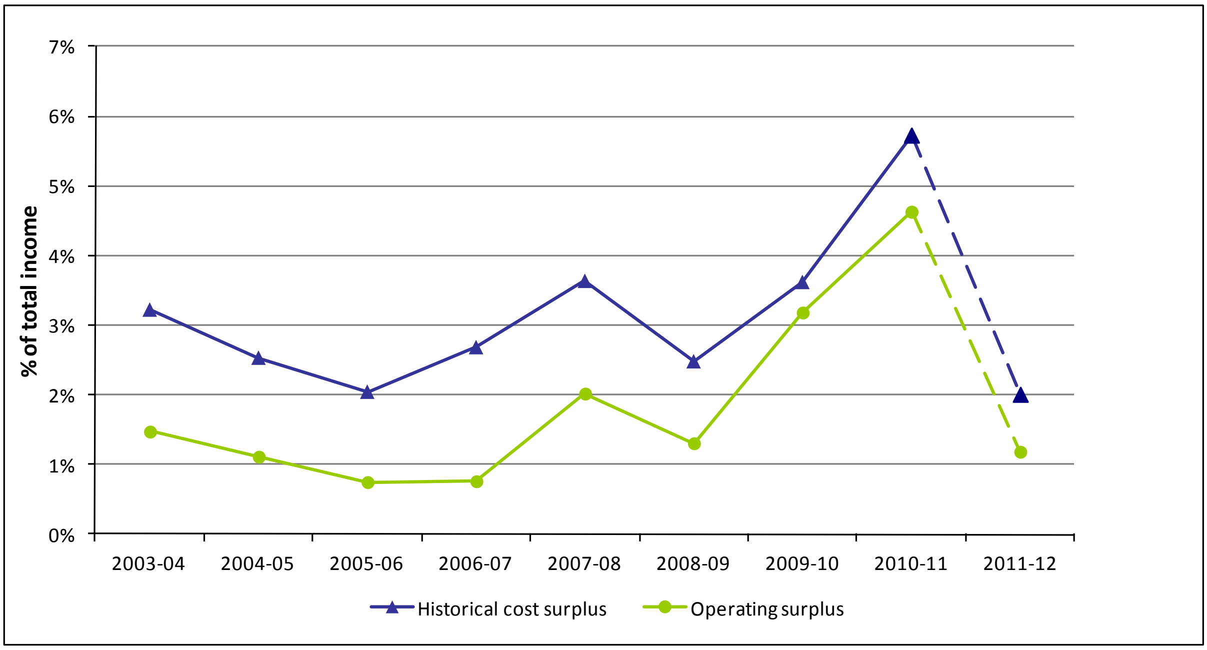
Figure 5 Operating surpluses as a percentage of total income (2010-11)



29. On a historical cost basis[7] the sector recorded a surplus of £1,314 million (5.7 per cent of total income), which again is significantly ahead of the average over the past 10 years (2.7 per cent). The large difference between the operating and historical position in 2010-11 is partly accounted for by exceptional items (for example profit or loss from the sale of properties or exceptional restructuring) totalling £89 million. Figure 6 shows the level of operating and historical cost surpluses as percentage of total income since 2003-04.

[7] Historical cost surplus/(deficit) is after adjustment for the difference between historical cost depreciation and the actual depreciation charged on revalued assets, and net gains realised on the disposal of revalued assets. Institutions may use either historical cost or revaluation to value their assets and the different bases of valuation will alter the operating results, so the historical cost surplus/(deficit) provides greater consistency for comparison of results between institutions.

Figure 6 Operating and historical cost surpluses as percentage of total income



Liquidity[8] and borrowings

30. At the end of 2010-11 the sector had net liquidity of £6,100 million, equivalent to 109 days' expenditure. This is the highest level on record and is substantially above the level forecast in April 2011, which was 84 days. This is consistent with UK non-financial service sector companies whose cash holdings, in the third quarter of 2011, were also the highest level on record.

31. This improvement in liquidity indicates that the sector has been building its cash reserves ahead of changes in the profile of public funding payments due to commence in 2011-12. This may have been at the expense of capital expenditure, which, at £2,590 million, was £556 million (17.7 per cent) less than forecast in April 2011. Only five institutions had liquidity of less than 20 days (compared to nine institutions in 2009-10).

32. Liquidity was also much higher than borrowings, which rose from £4,686 million to £5,040 million, equivalent to 22 per cent of income. At the end of July 2011 the sector had another £837 million of financing agreed with lenders but not drawn down. Between August and October the sector drew down £101 million of this borrowing.

33. Despite the increase in borrowings, interest payments fell by 17.3 per cent in 2010-11 (compared to a rise of 17.5 per cent in 2009-10). This might have been caused by the impact of low interest rates in the economy. The sector's annualised servicing costs rose marginally to 2.14 per cent of income in 2010-11 (compared with 2.10 per cent in 2009-10).

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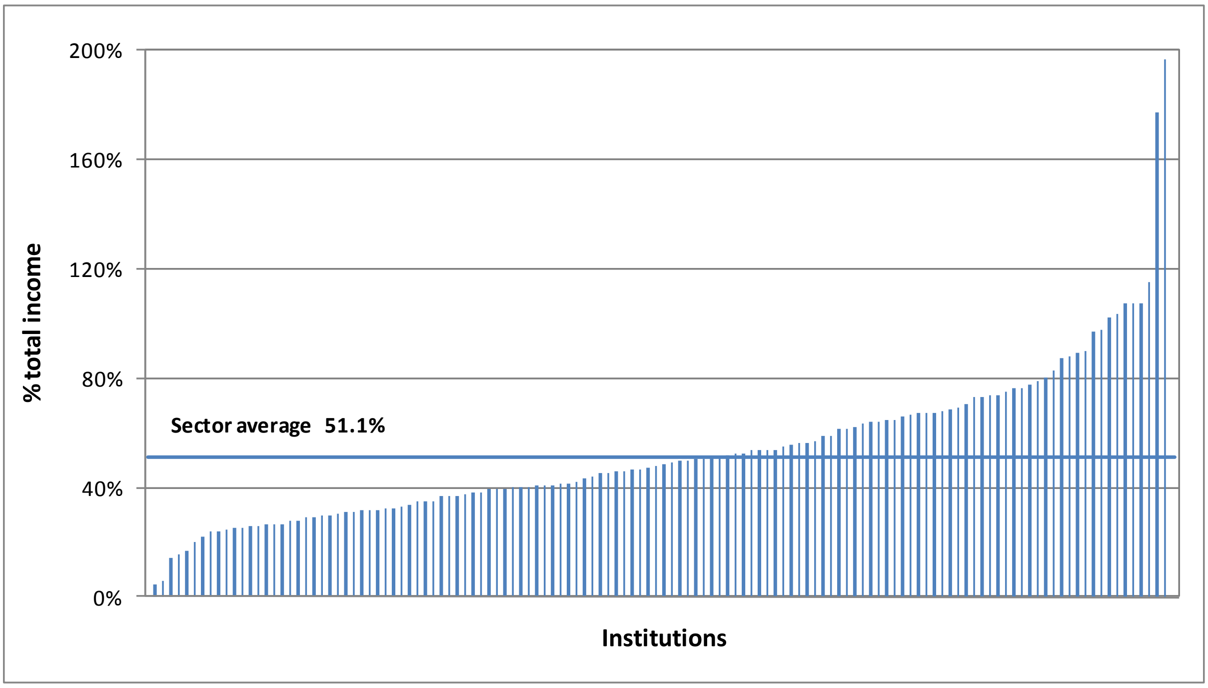
[8] Net liquidity = current asset investments plus bank and cash balances less bank overdrafts. The indicator is also expressed as the number of days' operating expenditure covered by the net liquidity.

Reserves

34. Discretionary reserves[9] at the end of 2010-11 totalled £8,682 million, after taking into account the impact of the financial reporting standard on retirement benefits (FRS 17). This reporting standard, which requires pension scheme surpluses or deficits to be included in the balance sheet (but not those of the Universities Superannuation Scheme because it is a multi-employer scheme that is unable to accurately identify assets and liabilities to individual HEIs) came into effect from 2005-06 and can make comparisons with previous years more difficult. Without FRS 17 the sector would have reserves of £11,720 million, equivalent to 51.1 per cent of total income. Total pension scheme deficits decreased by £336 million to £3,037 million, which reduced reserves to 37.9 per cent of income.

35. As reported in previous years, the aggregate sector financial position masks a significant spread of financial strength, with a concentration of large discretionary reserves in a small number of universities. Figure 7 shows the spread of reserves (excluding FRS 17) as a percentage of total income, reported as at 31 July 2011.

Figure 7 Discretionary reserves as percentage of total income (2010-11)



Cash flow

36. Cash flow from operating activities totalled £2,113 million in 2010-11, which compares favourably with the forecasts provided earlier in the year and cash flow reported in 2009-10 (£1,838 million). The level of cash flow in 2010-11 was equivalent to 9.2 per cent of total income, an improvement on the 8.3 per cent reported for 2009-10. The sector has been increasing its cash flow gradually each year since 2004-05, which is a positive indicator of solvency and is particularly important ahead of the public funding changes starting to impact in 2011-12.

[9] Discretionary reserves = expendable endowments plus general reserves from the balance sheet.

Financial forecast for 2011-12

37. Overall the projected sector financial performance for 2011-12, the first main year of transition to the new funding system, is weaker than 2010-11, but is expected to remain sound overall.

Income and expenditure

38. Total income is forecast to reduce marginally by 0.8 per cent to £22,749 million in 2011-12. Table 3 provides a breakdown of the income levels forecast and compares these to the last two years actual performance.

Table 3 Breakdown of income levels (cash terms)

£000s	**2009-10 Actual**	**2010-11 Actual**	**2011-12 Forecast**	***% annual change between 2010-11 and 2011-12***
Funding council grants	7,280	7,201	6,635	*-7.9%*
Overseas fee income	2,214	2,498	2,699	*+8.0%*
Other academic fees and support grants	4,918	5,257	5,449	*+3.7%*
Research grants & contracts	3,498	3,563	3,639	*+2.1%*
Other operating income	4,131	4,208	4,140	*-1.6%*
Endowment income & interest	180	196	187	*-4.5%*
Total	**22,221**	**22,923**	**22,749**	***-0.8%***

39. The sector, as a whole, has made realistic assumptions about the levels of funding from funding councils[10] in 2011-12 in its financial forecasts, which are expected to fall by 7.9 per cent compared to 2010-11. However, the forecasts predict an overall increase in income from Research Councils of 3.5 per cent in cash terms over the year; this follows a 2.1 per cent reduction in Research Council income in 2010-11. The predicted increase therefore looks optimistic.

40. The sector is expecting overseas (non-EU) student fee income to rise by a further 8 per cent in 2011-12, with 23 institutions expecting fee income to rise by over 20 per cent in 2011-12. At the other end of the scale, 36 institutions are forecasting overseas fee income to fall in 2011-12 (compared to 22 institutions reporting a fall in overseas income in 2010-11). This may indicate that some institutions are concerned about the impact of the latest changes in visa regulations. The latest available UCAS data indicate that non-EU applications have increased in 2011-12 and 2012-13, and, while we recognise that most non-EU students do not apply through UCAS, this indicates that the overall rise in income predicted by the sector is not out of line with the UCAS trend.

[10] This will include HEFCE, the Skills Funding Agency and the Training and Development Agency for Schools.

41. In 2011-12, the sector is expecting a marginal real-terms rise in total expenditure, with a 0.4 per cent real-terms rise in staff costs compared to 2010-11. As in previous years, at individual institutional level the predicted changes in staff costs vary, ranging from a reduction of 13.1 per cent to an increase of 12 per cent (in real terms).

Surpluses

42. The forecasts indicate that at an operating level the sector will see a reduction in its surplus in 2011-12 to 1.2 per cent of total income (a level similar to that reported in 2008-09). On a historical cost basis the level of surplus forecast will be 2.0 per cent, which is below the average over the past 10 years (3.2 per cent) but above the level forecast in April 2011 (1.5 per cent).

Liquidity and borrowings

43. The level of liquidity days is currently the highest on record. It is forecast to fall to 88 days at the end of 2011-12, which is a still a healthy level. Ten institutions expect to have liquidity of less than 20 days in 2011-12 (compared to five in 2010-11).

44. Liquidity is forecast to reduce to £5,086 million by the end of 2011-12, which is partly due to the sector's significant investment in its infrastructure. One indicator of this is the level of capital expenditure, which the sector is forecasting to increase to £2,867 million in 2011-12 (compared to £2,590 million in 2010-11).

45. To help finance these investments in infrastructure the sector continues to increase its borrowings. The sector is forecasting the level of borrowings to rise to £5,442 million at the end of 2011-12 (23.9 per cent of total income), which is £402 million more than at 31 July 2011. The sector also has access to over £736 million of financing agreed with lenders but not yet drawn down, which suggests that the availability of financing should be less of an issue compared to other sectors.

Cash flow

46. The sector is forecasting cash inflows from operating activities in 2011-12, but at a much reduced level than reported for the year 2010-11. However, this is to be expected in this first transitional year, when the sector moves towards the new funding arrangements, and it may not be sufficient to finance any expenditure plans not financed by capital grants or borrowings. The large capital expenditure forecast in 2011-12 will require close cash flow management.

Conclusion

47. Overall, the financial results for the sector in 2010-11 are stronger than those reported for 2009-10 (and much stronger than indicated in the sector's forecasts submitted to us in April 2011). The majority of the key sector financial indicators are the best on record, with the sector reporting strong surpluses, large cash balances and healthy reserve levels. These will help the sector manage the financial challenges arising from the transition to the new funding arrangements, which is already starting to impact in the current financial year.

48. The financial forecasts submitted for 2011-12 indicate that the sector will remain in sound financial health despite a reduction in income. While the overall position is reasonable, the

impacts of public sector funding reductions are starting to have an impact. The sector has made good preparations for the changes by re-aligning costs as necessary.

49. In June 2011 the Public Accounts Committee (PAC) published a report 'Regulating financial sustainability in higher education' following a PAC hearing in March 2011. One of the recommendations in the PAC report was that BIS writes to the PAC by the end of March 2012 setting out how well institutions are coping with the transition to the new funding regime. The focus of this was on the risk to the financial health of institutions. The information in this report will support the response to be made by BIS.

50. Despite there being uncertainty about the future government policy for higher education, in particular student number controls, there is strong evidence that the sector is financially well prepared for the new funding system. In addition to this the main risk identified by the sector was an unexpected reduction in student demand. This risk now looks unlikely to materialise in the short-term as the recent UCAS data indicate that student demand, for full-time undergraduate courses, is likely to exceed the number of places available in 2012-13.

51. There continues to be a large degree of uncertainty about how the new system will operate in the medium term (i.e. 2013-14 and 2014-15) in particular with regards to the policy of controlling student numbers. As the policy becomes clear we will need to re-assess the future financial prospects of the sector.